



Stock Focus

Stock Picks From A Guy Who Called Enron

Peter Lattman, 07.22.05, 8:30 AM ET

In stock research, sometimes it pays to listen to bond guys, and **Sean Egan** is one especially worth heeding. His research company, **Egan-Jones Ratings**, warned clients away from **Enron**, **WorldCom** and **Ford Motor**, among others, well before troubles at those companies became widely apparent.

At the moment, Egan is down on **Northwest Airlines** (nasdaq: [NWAC](#) - [news](#) - [people](#)), currently suffering from high leverage, record fuel prices and relentless pressure from expanding discount carriers. The airline's operating loss for the March quarter grew from a \$108 million loss last year to \$292 million this year, while interest expenses rose from \$132 million to \$151 million. "This company's problems are not going to be solved by charging 50 cents more for each package of peanuts," says Egan.

But besides the brag sheet of great calls, why listen to Egan-Jones? Unlike the two ratings agencies Standard & Poor's and Moody's Investors Service, Egan-Jones makes money selling its credit-ratings services to its big-money managers. Consequently, Egan-Jones, based in Wynnewood, Pa., avoids the substantial conflict of interest afflicting S&P and Moody's, which get paid by the corporations they rate. It is worth noting that Congress held hearings last month on the Credit Rating Agency Duopoly Relief Act, a bill introduced by Republican congressman **Michael Fitzpatrick**. The bill has bipartisan support and should open up the credit ratings industry to competition.

Egan-Jones employs what it calls a "holistic" approach to credit analysis. Rather than focusing solely on conventional bond metrics like leverage ratios, it looks at companies' equity market valuations and numerous other factors relevant to the assessment of credit quality. Examples: the chances of a share repurchase and the value of goodwill and other intangible assets.

Egan-Jones is also cool these days on **Verizon Communications** (nyse: [VZ](#) - [news](#) - [people](#)). The telecommunications provider faces pressure from declining margins, weighty acquisition costs and competing technologies. On the last score, Verizon is engaged in a fierce fight with **Comcast** (nasdaq: [CMSCA](#) - [news](#) - [people](#)), which is now aggressively rolling out voice-over-Internet Protocol phone service via the Internet.

Further, Egan believes Verizon's \$8.4 billion acquisition of **MCI** (nasdaq: [MCI](#) - [news](#) - [people](#)) was ill-advised. Not only is MCI's long-distance business becoming less relevant with VoIP, but the deal will prove a drag on Verizon's balance sheet. Watch for charge-offs in the neighborhood of \$1 billion resulting from the MCI purchase, says Egan.

How about a few bullish bets? One company whose prospects he likes now is **Cardinal Health** (nyse: [CAH](#) - [news](#) - [people](#)), the No. 1 U.S. drug distributor. Just over a year ago, the company's shares declined sharply when the company lowered earnings expectations and revealed investigations by the U.S. Department of Justice and the Securities and Exchange Commission regarding its revenue recognition policies.

But once Cardinal gets past the trouble with the authorities, Egan believes, it will likely thrive thanks to a robust earnings outlook, a healthy balance sheet and diverse product portfolio. The stock sells for a dirt-cheap 0.3 times sales.

Another company emerging from trouble that Egan-Jones recommends to clients: **Sotheby's Holdings** (nyse: [BID](#) - news - people). Though still reeling from a price-fixing scandal in 2000 that sent its largest shareholder, **Alfred Taubman**, to prison, the company has repaired its balance sheet by selling its real estate unit. According to Egan-Jones, Sotheby's should see future growth with the growing number of rich people in China and India.

Egan-Jones also spends time researching potential merger and acquisition candidates among the 1,000 companies it covers. On this front, Egan mentions credit-card outfit **Capital One Financial** (nyse: [COF](#) - news - people), an obvious buyout target on the heels of **Bank of America's** (nyse: [BAC](#) - news - people) purchase of **MBNA** (nyse: [KRB](#) - news - people).

In the finance realm, Egan also has his eye on **E*Trade Financial** (nyse: [ET](#) - news - people), which recently lost out to **AmeriTrade Holding** (nasdaq: [AMTD](#) - news - people) in a bidding war for TD Waterhouse USA. "Look for Schwab or another strong financial services firm to purchase it," predicts Egan.

Egan-Jones Calls: Positive

Company	Price	Change From 52-Week High	2006 Estimated P/E	EPS Growth*	Market Value (\$mil)
Capital One Financial (nyse: COF - news - people)	\$84.17	-1%	11	14%	\$22,179
Cardinal Health (nyse: CAH - news - people)	58.00	-5	17	12	24,839
E*Trade Financial (nyse: ET - news - people)	15.42	-1	14	10	5,702
Electronic Data Systems (nyse: EDS - news - people)	19.60	-16	29	15	10,170
Sotheby's Holdings (nyse: BID - news - people)	14.51	-25	17	15	931

*Annualized; projected over the next three to five years. Sources: FT Interactive Data, Reuters Fundamentals and Thomson First Call via FactSet Research Systems

Egan-Jones Calls: Negative

Company	Price	Change From 52-Week High	2006 Estimated P/E	EPS Growth*	Market Value (\$mil)
Delphi (nyse: DPH - news - people)	\$5.08	-49%	NA	8%	\$2,852
Northwest Airlines (nasdaq: NWAC - news - people)	4.75	-60	NA	NA	414
Rite Aid (nyse: RAD - news - people)	4.30	-16	43	2	2,240
Verizon Communications (nyse: VZ - news - people)	34.18	-19	13	6	94,582

Prices as of July 21. *Annualized; projected over the next three to five years. Sources: FT Interactive Data, Reuters Fundamentals and Thomson First Call via FactSet Research Systems

